Trade tensions simmering

Jason Draho

President Trump campaigned on the promise to take an “America First” approach to trade and international relations. His election raised concerns that this more nationalistic approach could increase geopolitical tensions. Those concerns were overshadowed at first by the Trump administration’s market-friendly actions on tax reform, regulatory relief, and spending initiatives.

Until recently, trade tensions remained on a simmer, with only minor episodic conflicts. That changed in March, when the Trump administration announced steel and aluminum tariffs and levies targeted at China (see Trade timeline, Fig. 1). These confrontational actions contributed to recent market volatility, bringing the S&P 500 into “correction” territory (10% below its all-time high) for the first time in two years.

As we discussed in our recent House View report, The Galton Board, the outcome of these trade tensions is uncertain. But while it’s difficult to account for all the possibilities, it is our view that the potential outcomes are not all negative. The US could successfully use its tariff proposals as a bargaining chip in other, more substantive, negotiations. The US-South Korea Free Trade Agreement (KORUS) is one recent example; the steel and aluminum tariffs also are factors in the ongoing North American Free Trade Agreement (NAFTA) discussions. Overall, America’s trade partners’ responses have been restrained and proportional, and we believe that US-China negotiations—now underway—will ultimately lead to a resolution.

Consequently, we assign a 20–30% chance that trade conflicts will escalate into a more meaningful clash with significant economic costs (see Global risk radar: Tariffs weigh on markets for more details). For now, the direct economic impact of the announced trade actions is very limited, and should represent only a minor speed bump for the global economy (~0.1% of GDP). This supports our currently positive view on risk assets. But President Trump is also anxious to reduce America’s trade deficit, which he views as a “scorecard” for whether trade is fair. Lack of progress on this metric, as well as other factors, would raise the risk that the administration ramps up its actions on trade.

VIDEO Jason Draho discusses this report’s highlights. Click to watch.
What to watch? Progress on negotiations

We believe we’re now in a “waiting game,” with the US and China seeking to negotiate a compromise before their tariffs go into effect. However, we expect episodic bouts of volatility to persist as both countries seek to posture in order to maximize their negotiating leverage. President Trump’s unorthodox and unpredictable approach is likely to result in a bumpy path, even if the outcome is ultimately positive for investors.

The White House’s ultimate goal is the renegotiation of existing trade agreements, not a full-blown trade war. The use of targeted tariffs is a way to bring this about, since their direct ability to reduce the US trade deficit is limited. The US will seek concessions from China on a number of fronts: Phasing out subsidies for domestic Chinese businesses, curtailing practices that force US companies to transfer intellectual property, eliminating licensing restrictions, and giving US companies latitude to operate in China without establishing joint ventures with Chinese firms. China will hope to pre-empt the US tariffs, as well as ensure that its concessions don’t negatively impact domestic growth or undermine the “Made in China 2025” initiative.

So far, there is cause for optimism in a negotiated outcome. First, the economic and political stakes are too high for the two largest economies to risk an all-out trade war. Second, China has signaled openness to negotiation and their retaliatory actions have been proportionate: China proposed a tariff on USD 3bn of US imports—sized to offset the effect of the steel and aluminum tariffs—and a set of USD 50bn tariffs to counter the Section 301 intellectual property rights tariffs. Third, there has been progress on updating NAFTA, and a deal would highlight the preference to reach a negotiated settlement.

Another reason for near-term optimism is that there aren’t many additional potential trade restrictions in the pipeline that the Trump administration could invoke. Most significant actions require a long vetting process involving multiple government agencies. The anti-dumping and countervailing duty cases currently under review at the Department of Commerce and International Trade Commission represent only about USD 3bn in imports.

However, there are many reasons why we can’t rule out escalation—especially over a longer horizon. First, there is always the risk of a miscalculation that causes an unintentional escalation. President Trump labeled China’s retaliatory tariffs “unfair” and asked the Office of the United States Trade Representative (USTR) to consider applying tariffs to a further USD 100bn of Chinese products. Second, the US trade deficit is unlikely to fall over the next year—in fact, it should rise if the fiscal stimulus boosts the US economy and increases demand for imports—which Trump may view as evidence that he hasn’t been tough enough. Third, the steel and aluminum tariffs were imposed using a “national security” exception that bypasses WTO limits—setting
a precedent that other countries could follow. Last, the incentive to impose tariffs will increase when the economy slows and the unemployment rate rises.

The base case: Minimal economic impact
The economic impact of trade restrictions, both real and perceived, will be critical in determining how the tensions evolve. Accounting for countries granted exemptions, the 25% steel tariff and 10% aluminum tariff affect less than 2% of US imports. Other measures, such as levies on imported washing machines and solar panels, have been even more limited.

The most substantial proposal has been the US Section 301 tariffs targeting China. The US currently imports about USD 2.4tr of foreign goods. Even if the US goes forward with a 25% tariff on USD 150bn of Chinese goods, this would affect 6% of US imports and—assuming no substitution—raise the cost of US imported goods by 1.5%. These direct economic effects are a rounding error on the US and Chinese economies (USD 19.4tr and USD 11.9tr, respectively), a fact made abundantly clear in Fig. 4.

By contrast, the economic costs of a full-on trade war would be significant. It’s difficult to isolate the implications for a single economy because of the complexity of global supply chains, but we would expect global growth to slow by 0.5% to 1% over a 12-month horizon, relative to our base case forecast. The small, open economies in Asia with large technology sectors could be especially vulnerable to intellectual property-related trade sanctions on China. Inflation effects are difficult to predict, since higher direct costs from tariffs would be offset by disinflationary pressures from slower economic growth.

This asymmetry is a strong incentive for cooperation and negotiation. This is reinforced by the interdependency of the US and Chinese economies. In 2017, the US accounted for about 14% of China’s total trade and the corresponding number for the US was about 16%. China also holds about 19% of all outstanding Treasuries owned by foreign investors at the end of 2017, which it cannot easily sell without incurring losses. With the US government set to run large budget deficits for the foreseeable future, it’s in neither country’s interest for the trade tensions to spill into the financing markets.

Fig. 2: The US trade deficit with China is by far its largest
2017 US imports and trade deficit by country, in USD billions

Fig. 3: With good reason, US blames tariff asymmetry
Average tariffs in % imposed on trading partners

Source: UBS, as of 28 March 2018

Source: World Trade Organization, UBS, as of March 2018
Investment implications

Section 301 of the Trade Act of 1974 gives the President broad authority—through the Office of the US Trade Representative (USTR)—to investigate and combat trade practices that are “unjustified, unreasonable, or discriminatory” against US commerce.

In August 2017, the USTR opened an investigation into China’s trade and intellectual property rights policies. That report, published in March, estimated that China’s policies resulted in at least USD 50bn in annual harm to the US economy. A subsequent report recommended a 25% tariff on Chinese imports—across 1,300 product categories—amounting to USD 50bn annually, or about 10% of total US imports from China. The proposal is now going through a 30-day period for public comments, after which the USTR will have until 18 August to finalize the tariff list. President Trump can wait up to 180 days after this August deadline to adjust and implement the tariffs.

Also as a result of the Section 301 probe, the USTR has launched a World Trade Organization (WTO) dispute on Chinese technology licensing practices and will investigate measures to restrict Chinese investment in US companies possessing sensitive technologies.

With higher stakes in an increasingly interdependent world, trade conflicts have become increasingly narrow and short-lived.

**Investment implications**

Fortunately, we don’t have a recent historical precedent for evaluating how financial markets would be impacted by a prolonged period of protectionism. With higher stakes in an increasingly interdependent world, trade conflicts have become increasingly narrow and short-lived. Unfortunately, this lack of precedents complicates our ability to assess the outcome of a “trade war” risk scenario.

That being said, stock markets have already responded negatively to simmering trade tensions, arguably much more significantly than is warranted based on the likely economic cost of the tariffs (Fig. 5). In a trade war scenario where global growth is one percentage point lower than in our base case, it would be reasonable to expect a larger sell-off for global equities. Export-oriented markets and companies, which depend on global trade, would be more negatively affected. Markets like Japan and Germany—whose stock markets have a large weight to machinery and car manufacturing stocks—would probably underperform the rest of the world. Within US stocks, the technology and industrials sectors appear particularly vulnerable because of their significantly integrated position in the global value chains.

**Fig. 4: Potential tariffs are trivial relative to the entire US economy**

GDP and imports are for 2017, in USD billions

<table>
<thead>
<tr>
<th>GDP</th>
<th>Imports</th>
<th>Imports subject to tariffs</th>
<th>Tariffs</th>
</tr>
</thead>
<tbody>
<tr>
<td>19,400</td>
<td>2,400</td>
<td>150</td>
<td>12.5</td>
</tr>
</tbody>
</table>

Source: US Census Bureau, UBS, as of 6 April 2018

**Fig. 5: The market reaction to the China tariff announcement far exceeds the cost**

Market’s reaction versus proposed tariffs, in USD billions

<table>
<thead>
<tr>
<th>Estimated tariffs on China</th>
<th>S&amp;P 500 market value decline (22 March)</th>
</tr>
</thead>
<tbody>
<tr>
<td>–12.5</td>
<td>–599.6</td>
</tr>
</tbody>
</table>

Source: Bloomberg, UBS, as of 28 March 2018

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**Related reading:**

UBS Global Risk Radar

This publication series helps investors identify and assess global financial market risks and their investment implications. The current issue focuses on investment implications as a result of increasing trade tension.
Final thoughts

A global trade war would also likely be negative for the US dollar. The imposition of tariffs has a one-off effect lifting prices, but also a prolonged negative impact on growth. We would expect the Fed to look through the price effect and become more accommodative to smooth the negative impact on growth. This would weaken the dollar, in particular against other major currencies.

**Final thoughts**

The current global trading system, with all its rules and interconnected supply chains, took more than 70 years to build, with US leadership being the driving force. It won’t be easy to reverse this, even if trade tensions continue to escalate. The economic benefits from this system are too large—and its institutions too deeply rooted—to reasonably expect otherwise.

Nonetheless, it’s clear that the rules of global trade need to be updated to better reflect economies that are increasingly dominated by services and intellectual property and the advances made by emerging economies over the past two decades. How we will get to that point remains uncertain and it will only be resolved over years, not months.

In the interim, trade tensions will continue to simmer, with pockets of volatility surrounding episodic headline risks. But we don’t expect these skirmishes to boil over into an outright trade war.

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**Twin deficits, joined at the hip**

The US trade deficit on goods and services has been widening since President Trump took office, exceeding USD 57bn in both January and February (Fig. 6). This may be one reason why he has put so much emphasis on this issue recently. But the Trump administration’s other signature policy actions have made it even more difficult to curtail this deficit.

Specifically, fiscal stimulus from tax reform and the 2018 budget deal are boosting US economic growth, but they could also be boosting the trade deficit. That’s because some of the higher US consumption—we estimate about one-third—will be spent on imports. Also, to the extent that corporate tax cuts benefit foreign owners of US companies, the US current account deficit, which includes investment income, will widen. This will be partially offset by foreigners using some of their higher after-tax profits to buy the extra government debt issued to finance the larger budget deficits.

Technically, these higher trade and current account deficits will offset the boost to GDP, but targeting a smaller trade deficit is a case of “be careful what you wish for.” The US economy is consumption-driven, and cheap imported goods are a boon for the US consumer. Trade deficits usually narrow sharply only during an economic crisis—often due to collapsing demand that causes imports to plunge.

As for the fiscal deficit, reducing it hasn’t been a priority of President Trump, but this could complicate his plans. In the event of a trade war, foreign investors may eventually demand a risk premium to buy US assets, making it difficult for the US government to be able to continue smoothly funding its deficits. That means some combination of higher bond yields, lower valuations on equities, and a weaker dollar. Those are steep prices to pay for a smaller trade deficit.

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**Fig. 6: The US trade deficit widened since Trump took office**

<table>
<thead>
<tr>
<th>Year</th>
<th>US monthly trade balance, in USD billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>0</td>
</tr>
<tr>
<td>2002</td>
<td>-10</td>
</tr>
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<td>2004</td>
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<td>2012</td>
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<tr>
<td>2014</td>
<td>-70</td>
</tr>
<tr>
<td>2016</td>
<td>-80</td>
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</table>

Source: US Census Bureau, UBS, as of 6 April 2018
John Savercool on foreign policy

**Jason Draho:** What is your base case for US-China negotiations? What tariffs will actually be imposed?

**John Savercool:** Some tariff increases are already in effect from the dispute over steel and aluminum, but they are not considered as significant as the threatened tariffs resulting from US concerns over alleged unfair Chinese trade practices and intellectual property theft. With regard to those tariffs, I believe there is a good chance they will never be imposed. The US and China will negotiate over the next six weeks and possibly longer to determine whether they can find agreement on the various trade issues that are causing tension, particularly intellectual property theft and the market access rules for US companies to operate in China. These will be very difficult negotiations, but neither side wants a trade war and each side has strong incentives to come to an agreement to avert the threatened tariffs.

**Draho:** What are other trade developments that investors should be watching?

**Savercool:** From the start of the Trump presidency, I believe the biggest trade challenge and potential threat to investors is whether the US will remain in the North American Free Trade Agreement (NAFTA). Threats of withdrawing the US from the agreement have caused significant heartburn in the business community and led to investor concern over a broader agenda of protectionism. I believe a US withdrawal from NAFTA would have a significantly adverse market impact, more so than the current debate over tariffs. I do not believe the US will withdraw from NAFTA, but I believe that possibility is the biggest trade issue lingering that investors should pay attention to.

**Draho:** With Gary Cohn and Rex Tillerson having departed the administration, which pro-trade advocates might have a moderating impact on President Trump’s protectionist approach?

**Savercool:** Larry Kudlow, the president’s chief economic advisor, supports free trade as do others in the administration. However, I sense that on issues relating to trade, the president will rely on his own counsel and make his own decisions. Trade was a core issue—perhaps the core issue—in the 2016 presidential campaign, so no one should expect President Trump to change the “fair trade” positions he took on the campaign trail. To a certain degree, the president must also listen to Congress on trade issues, specifically on any NAFTA revisions, since lawmakers have to vote on certain trade measures. Lawmakers have regularly inundated the president and his team with concerns over any possibility of pulling the US out of NAFTA since the election. Since their votes are necessary to carry out much of the president’s trade agenda, he must at least consider accommodating them to a certain point if he wants his trade goals enacted into law.

**Draho:** What impact do you expect from the administration’s new foreign policy leadership—especially Mike Pompeo as Secretary of State and John Bolton as national security advisor?

**Savercool:** The roles of Mike Pompeo or John Bolton will be much broader than trade advisors, but when the trade issues might complement or contradict national security issues, they will have significant roles. Trying to resolve trade issues with China is complicated, because they must be assessed in the context of making progress on dozens of other important issues we have with China, whether it be Chinese actions with regard to North Korea, China’s military build-up in the South China Sea, and the valuation of China’s currency, among other pressing issues. How to juggle all of these issues in a way that keeps the relationship balanced in a healthy way is a great challenge to diplomats from both countries. Nonetheless, President Trump has made it clear that he believes the trade issues are on the highest tier of those that define the relationship. Other parts of the relationship may suffer or be sidelined in the process.

**Draho:** If the US and China reach a negotiated settlement that helps to reduce the trade deficit, will protectionist pressures begin to abate?

**Savercool:** I think protectionist fears will linger even if the current trade disputes are successfully resolved. Other than the tariff issues and NAFTA, I don’t believe there are other imminent major trade issues on the short-term horizon. However, we all know the president’s strong views on trade and his use of trade deficits as the barometer for US trade success, so I believe these protectionist threats will continue to be revived as the president speaks (or tweets) on the subject.

**Draho:** What about other domestic policy and legislation agenda items? What would you expect to change after the midterms?

**Savercool:** As the schedule moves closer to the midterm elections in November, it will be very difficult for Congress to pass any major legislation. Yet, lawmakers will try. We believe there will be a strong effort to pass an infrastructure bill this year, though only a scaled back bill seems to have any chance of passing. Rather than a USD 1tr package, we expect a smaller bill—perhaps around USD 300bn—to have a small chance if the two parties can find agreeable ways to pay for the bill. Congress will also revisit an immigration bill, which is possible but also in a more scaled-back manner. I expect the focus of any immigration bill to be to restore the legal status for Dreamers. I believe final legislation on financial reforms for smaller institutions will pass in the summer or fall. More broadly, I am not optimistic that issues like privacy, healthcare, a farm bill, or any significant tax or spending legislation will pass this year.
### Priorities and impact: One year later

<table>
<thead>
<tr>
<th>Tax reform</th>
<th>Regulatory relief</th>
<th>Spending initiatives</th>
<th>Global engagement</th>
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<td><strong>What’s happened so far</strong></td>
<td>The Tax Cuts and Jobs Act—the most sweeping tax legislation since 1986—was signed into law on 22 December. The law permanently lowered the corporate tax rate from 35% to 21%, and implemented a “deemed repatriation” tax—at a reduced rate—for offshore earnings. Offsetting some of the benefits were a number of “base erosion” provisions that aim to limit US multinationals’ ability to shift income into low-tax, overseas jurisdictions. On the personal side, changes were more mixed. The law lowered personal income tax rates modestly (the highest tax rate was dropped from 39.6% to 37.0%), and increased the size of the child tax credit. But these changes expire in 2025, and the law also introduced limits for many personal deductions—most notably the State and Local Tax (SALT) and mortgage interest deductions.</td>
<td>The Trump administration has used executive orders and cabinet appointments to effect regulatory change. On financial regulation, the administration has leveraged executive actions and staff appointments—especially the Fed chairman and vice chairman for bank supervision—to roll back some Obama-era regulations. While most changes have come from the executive branch, Congress is also pitching in—the Senate recently passed a sweeping financial deregulation bill, currently being considered by the House. On energy and environmental regulations, examples include withdrawal from the Paris climate agreement, approval for the Keystone XL pipeline, proposed easing of automotive fuel efficiency standards, renewable fuels standards and/or to the associated biofuel credit system (RINS), and easing methane emission rules. Conversely, the Federal Energy Regulatory Commission has created uncertainty for existing pipeline infrastructure. Healthcare reform failed after several attempts to repeal the Affordable Care Act, though tax reform successfully ended the “mandate” penalty for uninsured taxpayers. After a series of government shutdowns and stopgap funding measures, Congress passed a budget on 23 March. The bill boosts the deficit by USD 300bn over two years, more short-term fiscal stimulus than the Tax Cuts and Jobs Act. The nonpartisan Congressional Budget Office (CBO) upgraded its short-term growth forecasts, largely to reflect higher deficit spending. But even with this stimulus the US budget deficit is expected to exceed 5% of GDP by 2022, and US debt will reach 96% of GDP by 2028 (from 78% in 2018). The Trump administration directed US agencies to streamline and simplify the environmental review process for infrastructure projects, with the goal of completing all reviews within two years. President Trump also asked Congress to undertake an infrastructure bill aimed at stimulating USD 1.5tr of investment over 10 years.</td>
<td>President Trump has taken a number of actions to renegotiate trade compacts. The administration withdrew from the Trans-Pacific Partnership discussions, kick-started a renegotiation of the North American Free Trade Agreement, and reached an agreement to amend the US-Korea Free Trade Agreement (KORUS). The Trump administration has also taken a series of unilateral steps to address trade imbalances, including levies on imported steel and aluminum, washing machines, and solar panels. The US has also proposed sweeping tariffs against Chinese imports in response to intellectual property theft. On foreign policy, the US has taken a mixed approach. On Russia, the administration has sought reconciliation but also implemented sanctions and spoken out against action in Syria. Other notable actions include the decision to move the US embassy in Israel to Jerusalem, and opening a direct dialogue with North Korea. The administration is also pursuing an aggressive approach to immigration, tightening enforcement at the US-Mexico border wall and within US borders.</td>
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| **What to watch** | • Corporate tax reform benefits will be included in earnings reports starting 1Q 2018. • What will companies do with the tax windfall and repatriated capital? • Will Congress attempt to make the personal tax cuts permanent? | • Will Congress or President Trump take action on drug price inflation? • Will the House pass the Economic Growth, Regulatory Relief and Consumer Protection Act? • Will the Department of Energy grant emergency subsidies to nuclear and coal power plants? • Will the Supreme Court rule that e-commerce firms are required to collect sales tax? | • Will President Trump send Congress a “rescission” bill to amend the budget? • Will Congress take up an infrastructure bill? | • Will US-North Korea talks yield an agreement? • Can the US and China reach an agreement to pre-empt their tit-for-tat trade actions? • What will be the outcome of other trade negotiations, especially NAFTA? • Will the Iran nuclear deal be terminated? |

| **Economic and investment implications** | We expect the tax package to boost US real GDP growth by about 0.25–0.50% per year in both 2018 and 2019, reducing the already-low recession risk over this period. Corporate tax changes should provide a sizable boost to earnings. We expect S&P 500 earnings per share to grow by 16% in 2018—about half of this comes from tax reform. | Regulatory reform is providing a tailwind for earnings—especially for the financials sector. For healthcare stocks, ACA repeal was less important than drug price regulation, a simming risk that hasn’t materialized. Over the longer term, reforms could boost productivity growth, which can be disinflationary and positive for economic growth. | Even under strong economic conditions, the deficit will approach 5% of GDP by 2019. Higher spending has reduced the already-low risk of a recession in the short term, but with little economic slack left it could stoke inflation. In the long run, the rising debt burden will likely mean higher taxes or entitlement spending cuts. But unless Congress generates another “debt ceiling” crisis or sustained government shutdown, we don’t anticipate an acute short-term crisis, and the US Treasury should still be able to find buyers for its debt. | US growth could suffer due to the negative impact from new trade barriers, tighter immigration, and an uneven foreign policy. The effects are likely to vary across countries and sectors. Tariffs, in particular, could be inflationary. |
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